47. Product standardization and the availability of natural benchmarks mean that regulators could, in principle, impose a reasonable set of performance criteria on an RBOC, and the assumption of stable technology, if valid, implies that the beneficial effects of the initial regulations are more likely to be irreversible.[34] Even here, however, the regulator would have to detect and punish adoption by the RBOC of a contrived change in technology that would not have been adopted but for the fact that it would allow the RBOC to force its competitor-customers and regulators to start over in negotiating and regulating new performance criteria for the sale of unbundled elements. Thus, the set of circumstances where regulation can be relied upon to protect the competitive process appears limited and, therefore, UNE-based entry will probably not result in effective local competition.

C. Measuring effective local competition.

48. The framework for assessing market power and competition is provided by the modern economics of industrial organization. The mainstream view in industrial organization is sometimes referred to as the structure-conduct-performance paradigm. This paradigm provides the conceptual basis for the *Merger Guidelines,* which are used by federal antitrust authorities (and many federal courts) in analyzing mergers and other antitrust issues. The overall concepts for assessing the degree of market power or competition found in the *Guidelines* are applicable to

[34]Indeed, enormous welfare gains can be realized by government standard-setting, even where private firms, absent the government-imposed standard, would choose noncompatible, proprietary standards. The terminal equipment market became far more price competitive and exhibited far greater technological change after the FCC imposed standards that sharply reduced the ability of the Bell System to prevent interconnection of non-Bell equipment.

assessing competition and market power issues quite generally, and not just in the context of a merger. The basic *Guidelines* framework is applicable to measuring effective competition for purposes of implementing the reforms called for by the 1996 Telecommunications Act, although some extensions of that framework are necessary in the context of a firm with market power whose pricing is effectively constrained by regulation. The FCC has previously endorsed the principles in the *Merger Guidelines* in its RBOC non-dominance order. The discussion below uses the concepts from the *Merger Guidelines* and the structure-conduct-performance paradigm for assessing the degree of local competition.

49. In unregulated markets, the absence of unilateral market power is generally inferred from either a low (enough) share of total capacity or, even if the firm in question has a high market share, by the demonstrated ability of its competitors to rapidly increase their market shares at prevailing prices. In a regulated market, however, a necessary condition to infer the absence of market power is that the firm's price is below the regulated maximum.[35] A firm with market power may, of course, find it profitable to set its price below the regulated maximum levels, but pricing by a monopolist or dominant firm at the maximum allowed by regulation clearly implies the existence of at least some unexploited market power. In that latter case, whatever competition exists is not yet sufficient to replace regulation as the constraining force on the

[35]We assume that the regulated price is not below the competitive level. If a regulated firm's prices are set below competitive levels by regulators, the market valuation of the firm's assets would be below book levels. This is hardly the case for the RBOCs.

dominant firm's pricing. For example, consider access charges. Access prices far exceed costs, by any measure,[36] but the RBOCs' access prices have consistently been at the regulated ceiling, indicating that if regulation were to be withdrawn, the RBOCs would find it profitable to raise prices even further.

50. Whether regulated maximum prices are binding is important for more than just establishing market power. The incentive to cross-subsidize or discriminate against downstream rivals depends importantly on whether competition or regulation is constraining that firm's prices in upstream and/or downstream markets.

51. In evaluating the likely effects of allowing an RBOC into long distance, therefore, a very important question will be whether the RBOC has been pricing consistently below its regulated maximum prices in both downstream and upstream local markets for a significant period of time and can be expected to continue to do so in the future. In downstream retail markets, where the sunk cost of entry through UNEs or resale will be lower and thus entry more likely, pricing below the regulated maximum price for a significant period of time may be sufficient to infer that competition rather than regulation is likely to continue as the constraining force in that market. In the upstream, UNE market, however, where the sunk costs of entry are much larger and entry

[36]Salomon Brothers observed that "switched access priced at $0.03 per minute is probably one of the highest margin legal businesses in the U.S." See Salomon Brothers, Regional Bell Operating Companies - Opportunities . . . While Danger Calls, January 1996, p. 20.

barriers greater, an inference of continued effective competition requires assurances in terms of both current performance and structure. If an RBOC has consistently been pricing all UNEs at levels below the regulated maximums and its facilities-based competitors at the upstream level have a sufficiently large share of upstream capacity, one can infer that competition will continue to be the constraining force in those upstream markets.

52. Because entry will probably occur far more slowly at the upstream, UNE stage, the state of competition there will determine how long the RBOC will retain market power in the local exchange and the resulting incentive to leverage market power into adjacent markets. But how should regulators determine when sufficient facilities-based entry has occurred to ensure competition has eliminated the RBOC's incentive and ability to engage in anticompetitive behavior? At a minimum, that point will have arrived when regulation of UNE and retail prices is no longer necessary. Any determination that the RBOC's retail and UNE rates should no longer be regulated would best be made by the state public utilities commission. If the RBOC cannot convince its state regulator that profit and rate regulation is superfluous and unnecessary (presumably because any price increase following deregulation would be "insignificant"), a substantial degree of skepticism is warranted that effective competition exists in fact for the RBOC's local exchange services. Regulation is expensive, and a state regulator acting in the interests of consumers and taxpayers should be willing to stop regulating the RBOC's rates and profit levels if it is convinced that competition is now almost as good as regulation in constraining the RBOC's prices at the retail and UNE levels.

53. Under the market share standards generally used in antitrust,[37] an RBOC would be presumed to still posses market power, before considering other factors, as long as it retained a market share above about 60-70%. Other factors could alter the presumption in either direction; shares above that level might not convey market power, and market power could still be present with shares below that level. However, the entry barriers raised by the substantial sunk costs associated with entering the local exchange market on a facilities basis strongly suggest that, but for regulation of its retail and UNE prices, an RBOC would be able to exercise substantial market power as long as it retained a large share of upstream capacity.[38] Moreover, any presumptions for RBOC entry into long distance based on market shares would require that the geographic market was defined correctly.

54. It is clear, however, that the correct geographic markets are far less than statewide in scope. The "local" in local exchange service is not a misnomer: The arena for effective competition with an RBOC is in fact very local. A customer does not yet have an effective

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[37]Regulation may prevent the direct and complete exercise of market power by limiting the firm's prices and profits, but, as we have stressed, this very constraint gives rise to incentives to take the monopoly profits in adjacent, unregulated markets.

[38]Because we have so little experience with local competition, it is not possible to say now which share measures will be most useful in assessing an RBOC's market power. If it turns out that entrants can quickly convert capacity to sales by slightly undercutting the RBOC's prices, then capacity measures of market share will be more appropriate. If it is very difficult for entrants with capacity to gain sales even if they slightly undercut the RBOC's local prices, then sales-based market share measures will be more appropriate.

competitive alternative unless the competing local carrier can provide retail local exchange services that are a) equivalent in price quality (or in quality-adjusted price) to the RBOC's offering and b) not dependent on the RBOC for any element or service that is essential for providing those final services to that customer on a cost-effective basis. Effective competition thus is assessed on a customer-by-customer basis: Just because a customer in city A has meaningful local service alternatives does not imply that another customer in city B halfway across the state has similar alternatives, nor does it imply that the customer in city A has local service alternatives for local termination of calls to city B. Similarly, just because one customer has a meaningful alternative does not mean that other customers a small distance away in the same city also have meaningful alternatives. For example, the sunk costs of extending service from a fiber ring to a building a few hundred feet away from the ring can be substantial,[39] in which case service via the fiber ring is not a meaningful alternative for customers very close to, but not on, the ring.

D. The potential for rapid growth of new local competitors cannot now be assumed sufficient to force an RBOC to price its services at competitive rates.

55. The "easy entry" argument posits that the potential for growth by facilities-based competitors is very high, so the de minimis shares of existing local competitors do not imply that an RBOC will retain market power and the ability to discriminate in the near future. In economics jargon, a market where high market shares don't imply market power because of very

[39]See Hatfield Associates, Enduring Local Bottleneck II, April 30, 1997.

easy entry is termed a contestable market. Because of the high sunk costs of facilities-based entry, or UNE-based entry, the local telecommunications markets are not contestable.[40] It is important to understand why.

56. At most, the argument is highly geographically specific. Consider first the case where the entrants' combined market share in one locality is small. For an alternative carrier to be a meaningful alternative to a current customer of an RBOC, that alternative carrier must face at most insignificant customer specific sunk costs to reach additional customers. If in fact actual local competition is limited to a few niches because the competitors face significant sunk costs to expansion, then a regulated bottleneck monopoly remains, and allowing the RBOC to enter long distance would entail substantial risks to competition. Excessively high non-recurring charges for unbundled network elements are a good example of customer specific sunk costs that inefficiently deter entry.

57. Now consider whether effective local competition in city A implies that an RBOC will soon face effective competition in other areas. In essence, the RBOC would be arguing that effective competition in city A implies that rapid expansion is both feasible and likely in other areas in the face of an exercise of market power. In order to reach that conclusion, however, one

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[40]Even economists who often work for the RBOCs recognize that "contestibility . . . certainly does not apply to telecommunications." See Jerry Hausman and Timothy Tardiff, Antitrust Bulletin (1995).

would have to know either that entrants have sunk or are in the process of sinking the costs necessary to enter the other areas (but do not yet have much market share), or that other markets are similar in all important respects to the city A, so that profitable entry in city A can be expected to be reproduced elsewhere. However, when local entry occurs in a systematic order (e.g., first in high density areas), entry in one area clearly does not imply that similar entry will occur elsewhere.

58. Problems in obtaining entry at multi-tenant buildings can also impose costs that make it uneconomic for a CLEC to provide service to the building even though it is a "short" distance to the CLEC's network. Because of the possible costs of dealing with more than one local telephone company, building owners may be reluctant to allow a CLEC access equivalent to that of the incumbent LEC to the common telephone spaces in the building. The entry-retarding effects of this natural or cost-based impediment to local entry can be exacerbated by exclusionary contracts between the incumbent LEC and building owners.[41] For example, contracts for exclusive rights of building access for local service marketing will raise the costs of entry. If incumbents are allowed to direct elements of competition between themselves and new entrants to a bidding contest over exclusive rights, the extent of entry will likely be reduced.

[41]See In the Matter of Annual Assessment of the Status of Competition in the Market for the Delivery of Video Programming, CS Docket No. 96-133 (December 26, 1997), at paragraphs 196-200.

59. The Federal Communications Commission should pay close attention to data comparing the rate at which an RBOC can enter into long-distance service with the rate at which local competitors can enter local service with UNEs purchased from the RBOC. The RBOC controls an important feature of both entry scenarios: It processes and implements the changes consumers make in their long-distance carrier, and it also must process and provide orders whereby new local competitors serve their customers in part with unbundled network elements obtained from the RBOC. Right now, those two entry processes would occur at enormously different rates. RBOCs now process thousands of PIC changes per day in long distance, utilizing well-tested and computerized methods. The RBOCs' ability to supply unbundled loops (or other UNEs) to local competitors is nowhere near as well developed. Obviously, if an RBOC can enter long distance at a far faster rate than it permits others to enter local service, it will have an enormous competitive advantage in competing for those customers who, for whatever reason, prefer one-stop shopping. (Other one-stop shopping issues are addressed in detail below.)

E. The risks of premature entry by the RBOCs into interLATA long-distance service are far greater than the risks of delaying their entry until local competition is well-established.

60. RBOCs may argue that they will face a competitive disadvantage in local competition if their local competitors can compete on an integrated basis, while they are denied authority to offer interLATA service. They also may object that the FCC can always rescind a grant of interLATA authority if the Commission later decides that, because of post-entry anticompetitive

behavior, RBOC provision of interLATA service is not in the public interest. These arguments are related, and both are fallacious.

61. Once an RBOC has been allowed into interLATA long distance, there is good reason to believe that, except for grossly egregious behavior by the RBOC, the decision will not be reversed easily. The FCC will not want to tell customers that they can no longer deal with their chosen vendor, even though that customer preference may be based on discrimination or cross-subsidy. Switching costs will be imposed on customers. The reality is that regulators are likely to view interLATA entry approvals as irreversible, with the removal of authority, once granted, viewed as highly unlikely absent truly egregious behavior.

62. When a decision is irreversible, and there is uncertainty that can be resolved by waiting, then it is optimal to wait for new information so long as the information will resolve some of the uncertainty[42] and the costs of waiting are low. This applies to public as well as private decisions. Here there are two major sources of uncertainty. The first concerns what terms and conditions will apply to competitors' future purchases of unbundled network elements from RBOCs and what principles the regulators will use for determining those terms and conditions.[43] The second concerns how well the procedures for purchasing unbundled elements actually work in practice

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[42]See Avinash Dixit and Robert Pindyck, *Investment Under Uncertainty*, Princeton University Press (1994).

[43]This uncertainty has been increased by litigation filed by the RBOCs and some state commissions to overturn the FCC's rules under the 1996 Act.

and how much local competition based on these procedures will develop. These issues can only be resolved by waiting and basing judgments on the actual terms and conditions for the purchase of UNEs, and the actual procedures as they work in practice.

63. The RBOCs cannot argue plausibly that there is a significant social cost to waiting. If they argue that it will take a long time to iron out the details for implementing transactions for unbundled elements, the implication is that, for a long time, entrants will be subject to seemingly plausible difficulties and excuses that impede local entry. But the FCC and state regulators are unlikely to impose major penalties on RBOCs where the troubling behavior falls in a gray area. Even where an RBOC is told to alter its practices, unless the regulator is convinced that its explanations for delays and problems are entirely without merit, the only likely remedy is forward-looking injunctive relief.[44] This gives the RBOCs a substantial ability and incentive to delay any efficient local entry that depends on their cooperation.[45]

64. The current strategies and investments of many telecommunications companies, including MCI, are premised, in part, on the perceived preferences of some telecommunications consumers for one-stop shopping. To the extent consumers in fact turn out to prefer one-stop shopping, a natural question is the effect of such preferences on the timing of RBOC entry into

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[44]This not a mere theoretical prediction. As reported above, Ameritech's only penalty for the repeated rejection of its tariff filings for interconnection and unbundled loops by the Michigan Public Utilities Commission was to be told to refile.

[45]Imagine if the IRS's worst sanction were to tell tax evaders to go and sin no more.

long distance. The RBOCs generally suggest that they will be disadvantaged unfairly if their entry into interLATA long distance is delayed after the IXCs begin to provide local service. This argument is without merit. One must consider carefully why there may be a customer preference for one-stop shopping. Consider three possibilities:

> 1) The consumer wants "one-bill" service. The RBOCs have the power today to make one-bill service work for their customers. By pricing their billing services reasonably, RBOC local service offerings can remain billed in conjunction with those of the IXCs, and the RBOCs should not be inefficiently harmed in local service competition for customers with a preference for receiving only one telecommunications bill. The prices for the RBOCs' billing services may have to be reduced, but that merely reflects the beneficial effects of competition on the now excessive prices the RBOCs are able to charge for their billing services.
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> 2) A preference for one-stop shopping might be based on various possible discount plans or price structures that encourage bundled purchases of local, long distance, and other services. Such pricing can be efficient. As discussed above in the context of access price reform, however, the major issue here arises if RBOCs are permitted to offer long-distance service before access price reform. Then the RBOCs can offer various attractive pricing plans (including price plans that bundle long-distance and local services) to all their customers, whereas entrants can only do so for customers they serve with their own switching facilities.[46] The out-of-pocket costs for a RBOC are far lower than the out-of-pocket costs for an IXC because of the large differential in each

[46]Delaying RBOC entry would give IXCs a pricing advantage only with respect to the small fraction of customers who they will serve with their own switches. Suppose after one additional year of local service competition, 2% of the customers in an RBOC's territory are served by someone else's local switch. If the RBOC is allowed to offer in-region interLATA service now, it will have a strategic pricing advantage for 98% of the customers. If the RBOC's long-distance entry is delayed, its rivals will have an advantage for only 2% of the customers. In a perfect world, society would not have to accept either inefficiency. However, as long as the Telecommunications Act is interpreted as requiring that the interLATA authority be granted or denied on a state-by-state basis, then, given the choice between the two distortions, there are two reasons to delay RBOC's entry. First, the distortion associated with delaying RBOC entry is far smaller than the distortion associated with permitting entry now. Second, local service is now monopolized, whereas very substantial competition exists in long distance. Thus, encouraging additional local entry is more important to society than allowing immediate additional entry into long distance.

company's true, private cost of access. Therefore, for all customers who cannot be reached by the IXC's facilities in such a way that allows the IXC to avoid paying access charges to the RBOC, the RBOC will have a substantial advantage in structuring attractive pricing plans. This advantage creates at least three problems. First, such an advantage could allow an inefficient RBOC to succeed in long-distance competition against a more efficient IXC solely because of the differential costs of access. Second, competition among facilities-based providers of one-stop shopping is necessary in order to maximize consumer benefits. If only the RBOC provides one-stop shopping, it will keep as profits much of the consumers' perceived benefit for one-stop shopping. Those profits can only be competed away when substantial facilities-based entry occurs. Third, to retain the competitive advantage against other long-distance carriers it gains from being solely able to more efficiently price bundled services, the RBOC's incentives to restrict the development of local competition are increased, since the RBOC is now the incumbent "first-mover" in both local and bundled services. Facilities-based local competition attacks both incumbencies.

3) A market preference for one-stop shopping might evolve to reduce "finger pointing" among multiple suppliers over service, maintenance, etc. This is a "Williamsonian" transaction cost argument,[47] and it is based on a failure of third parties (such as courts or regulators) to efficiently resolve contractual disputes. Given contractual failure, vertical integration occurs. But the RBOCs can't have it both ways. They argue that regulation will work very well and, therefore, they will not be able to discriminate in service quality, maintenance, etc. This presumes that either the courts or regulators will efficiently administer the "contracts" governing the sale of inputs by the RBOCs to their local competitors and to their long-distance customers. If these contracts are efficiently enforced, this reason for vertical integration is not present.[48] If the transactions costs advantage of vertical integration is real,[49] then the RBOCs' arguments

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[47]See Oliver Williamson, Markets and Hierarchies: Analysis and Antitrust Implications, New York: The Free Press (1975).

[48]Consumers may want a single point of contact for their telecommunications needs. If contracts work well, that point of contact need not be vertically integrated. In principle, either an RBOC or an unintegrated IXC could be the single point of contact and provide bundled service to its customers. The IXC would assemble its bundle by contract. However, if contracts don't work well, then customers only get efficient service from suppliers who are vertically integrated on a facilities basis.

[49]We do not suggest that vertical integration is necessarily efficient even if the transactions costs economies are real. One reason why consumers might prefer an integrated seller is if they know that, due to pervasive discrimination by a vertically integrated input monopolist, all

about efficient regulation are incorrect. And it will then be the competing IXCs and their customers, and not the RBOC, who would suffer the competitive disadvantage if RBOCs can provide interLATA service before facilities-based local competition is widely established.

65. In fact, it is the RBOCs who will have major advantages in competing for customers who prefer to purchase a bundle of services if the RBOCs are allowed into long-distance service before meaningful local competition develops. The RBOCs will be able to take advantage of a very well functioning wholesale market for long-distance capacity to offer immediately a bundle of services to their customers. They will not need the cooperation of any particular IXC to serve such customers. In contrast, of course, MCI's ability to offer a bundle of local and long-distance services will, for the near term, be almost entirely dependent on the nature of the cooperation for both local and long-distance services that it receives from the RBOCs. With premature interLATA entry, the RBOCs will be the sole provider of bundled local long-distance service, and we should expect that bundle to be sold at the monopoly price.

V. ANALYSIS OF BELLSOUTH'S ECONOMIC ARGUMENTS CONCERNING TRACK B ENTRY AND REGULATION

68. To briefly summarize our analysis (which is broadly consistent with the economic analysis provided by DOJ in Dr. Schwartz' affidavit), the Commission should rely heavily on a

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unintegrated sellers offer inferior service. One solution to that problem is to ban vertical integration by the input monopolist. This removes the anticompetitive motivation for the monopolist to discriminate among downstream firms.

demonstration that facilities-based competition is irreversibly established. BellSouth's economists reject this position, but on grounds that cannot be defended on any logical basis.

69. They contend that no mix of actual, facilities-based competition needs to be added to regulatory safeguards. BellSouth's economists argue that so long as the South Carolina regulator asserts it can police anticompetitive behavior and efficiently regulate access to BellSouth's local service elements, a proper cost-benefit analysis favors immediate entry by BellSouth into interLATA service in South Carolina. They argue that, on the one hand, there is no potential inefficiency or harm to competition from BellSouth's entry into long distance because regulators and courts, and especially the South Carolina regulator, will efficiently resolve any disputes that arise; and that, on the other hand, there are efficiencies and benefits to the competitive process from allowing BellSouth to provide interLATA service in South Carolina now.

70. But there are neither valid logical nor empirical bases for this conclusion. Let us revisit the steps in the logic of BellSouth's economists.

A. The economic logic in support of Track B authority is not valid.

71. The economic arguments advanced by BellSouth's economists, and in particular by Dr. Woroch, in support of Track B authority are simply incorrect. Dr. Woroch argues that in states like South Carolina, where local entry supposedly will be delayed relative to other states due to demographics and due to the relative absence of business activity that is telecommunications-

intensive, allowing the RBOC into long distance will speed the development of local competition. The argument is based on several assumptions.

72. First, he assumes (paragraph 5) that regulations governing local entry will allow any efficient local service entry using unbundled elements purchased from the RBOCs to occur, and that the various safeguards against discrimination will work. Thus BellSouth has done all it can do to prepare the way for local entry.

73. Second, he assumes (paragraph 18) that, prior to the grant of interLATA authority to BellSouth, the IXCs would refrain from investing in South Carolina either because the purely local investments are not profitable, or because the IXCs are collusively refraining from local entry in order to prevent BellSouth from entering long distance. However, if BellSouth is allowed to provide interLATA service, Dr. Woroch assumes the major IXCs will then invest in their own local facilities.

74. Dr. Woroch's prediction that the IXCs will commence facilities-based entry into local service only after BellSouth is allowed into long distance could be true for one of three reasons.

a) The IXCs know they will then be discriminated against as long-distance carriers. So long as BellSouth is excluded from interLATA service, it cannot act on its incentives for internal favoritism (and therefore the IXCs have less interest in local entry in low density areas like South Carolina than in other parts of the country). But once BellSouth gets interLATA authority for

South Carolina, each IXC sees greater profit in local entry in South Carolina in order to avoid, as best it can, the discrimination that will soon follow. This reason for IXC entry, obviously, is valid only if regulation cannot efficiently prevent discriminatory behavior, in contradiction to Dr. Woroch's first assumption.

b) The IXCs may be collusively avoiding local entry. Dr. Woroch does not explicitly claim that the absence of significant, facilities-based local competition in South Carolina is due to collusion among the IXCs,[50] but we see no way, absent collusion, to reach his conclusion on a logical basis. To be clear, we are saying that collusion is a logical possibility: However, it is not consistent with the facts.[51] For one thing, all the major IXCs are making significant investments in other states to enter local service. Collusion to avoid local entry should be more profitable in states with denser populations and more telecommunications-intensive businesses. Because significant resources are being spent by the IXCs to enter in these areas, collusion can hardly explain the very low levels of investment by the IXCs to provide local service in South Carolina.

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[50]Indeed, Dr. Woroch argues that local service entry is far less attractive in South Carolina than elsewhere, which, if true, would make it implausible that collusion by the IXCs explains the absence of local competition in South Carolina.

[51]MCI's projected losses this year for its local service business are about $800 million. And MCI had to spend far more than that in total entry costs to lose the $800 million. The magnitude of these losses was viewed by the stock market as evidence that local telephony was going to be far more expensive to enter than was previously thought. We strongly doubt that any reasonable court or regulator, after examining the facts, would conclude that MCI has pulled its punches by avoiding profitable entry into local telephony.

c) It might be thought the IXCs would feel forced to invest defensively in local operations if BellSouth were granted interLATA authority even though such investments were not profitable before. Dr. Woroch believes that (paragraph 17) the ability to jointly market, or provide one-stop shopping, makes the RBOCs especially potent potential competitors. But an IXC could realize the benefits of one-stop shopping by entering local service today. The fact they have not done so means that the benefits from the investment (increased future profits due to bundling) are less than the costs that would have to be incurred to be able to offer a facilities-based bundle. The IXCs may choose to respond to BellSouth's entry in some way, but there is no reason the response would include a strategy (investing in local facilities) that was available to them, and rejected as not profitable, before. The IXCs today compete with each other on pricing, quality, promotions and advertising, and other dimensions. Any response to interLATA entry and bundling by BellSouth would be chosen from among these previously used strategies, and not strategies previously rejected as not profitable. Dr. Woroch offers no reason why the IXCs' response will necessarily include investing significantly in their own local service facilities in South Carolina.[52]

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[52]Indeed, the danger of premature entry by BellSouth in South Carolina is that future local service investments by the IXCs and other CLECs will be rendered unprofitable when such investments might otherwise have become profitable. The costs of local entry are supposed to decline over time as the RBOC implements the required market-opening measures, and moves down the learning curve to make the UNE and resale processes work better and cheaper. If BellSouth gets the carrot of interLATA authority too soon, its incentives to make the UNE and resale processes work better are reduced substantially.

75. Third, Dr. Woroch argues (paragraph 19) that one need not believe the IXCs are pulling their competitive punches in local service to warrant Track B authority. He argues that CLECs without long distance businesses, and therefore without a strategic incentive to forbear from local entry, will nonetheless hold back on local entry. They know that if they enter, BellSouth will get Track A authority, which will lead in turn to facilities-based local entry by the IXCs. Because the South Carolina market probably cannot support that many local competitors, the IXCs' local entry will destroy the value of the non-IXC CLECs' investments. Recognizing this chain of events, other CLECs won't enter in South Carolina. Therefore Track B authority is necessary to get local service competition started in South Carolina.

76. This logic is also incorrect. Dr. Woroch ignores several ways the first CLEC to enter can profit if the IXCs later decide they need local service alternatives. The IXCs could purchase services from the CLEC and resell a bundled service. One or more IXCs could enter into a joint venture with the CLEC. Or an IXC could buy the CLEC, and possibly sell its services to other IXCs. Dr. Woroch assumes none of these options (all of which would increase the value of the first CLEC's investment) will happen. Rather he assumes the IXCs' only option is to invest in their own facilities. Given the enormous sunk costs necessary to enter local service with one's own facilities, and assuming (with Dr. Woroch) that small local markets like South Carolina's cannot support three or more facilities-based local competitors, there are gains from trade between the first CLEC to invest and the IXCs. We would therefore expect that the first CLEC will either sell its services to the IXCs or integrate partially or completely with one of the IXCs.

To believe otherwise, at least under Dr. Woroch's assumptions, would require that the IXCs and CLECs act irrationally. In short, the only strategic alternative for the IXCs considered by Dr. Woroch -- facilities-based local entry -- which would in fact reduce the expected return to local service investment by an unintegrated CLEC, is dominated by other, more profitable alternatives for the IXCs that would push other CLECs toward earlier entry. Therefore Dr. Woroch's theoretical prediction -- that even if BellSouth does open its market to efficient local entry, such entry will not occur even by unintegrated CLECs -- is incorrect.

77. Indeed, if BellSouth is correct that in South Carolina and elsewhere its local markets are open to efficient entry, then why haven't the RBOCs and major ILECs from other areas entered? Either the RBOCs have an understanding that they won't enter each other's territories, they are inefficient in the provision of local service, or they believe that efficient entry is not profitable.

B. The reliance by BellSouth's economists on regulation is unwarranted.

78. BellSouth's economists put substantial faith in regulation to prevent BellSouth from acting on its incentives for anticompetitive behavior. This faith is not warranted.

79. First, they uniformly assert that because discrimination by BellSouth against its competition in either the local or long distance markets (assuming it is allowed to enter long distance) is illegal, it simply won't happen. These assertions are quite surprising. There is a substantial law and economics literature on the economics of crime and punishment. To our

knowledge, no contributor to that literature has ever claimed, as BellSouth's economists uniformly do, that merely outlawing an activity, without prescribing adequate penalties for violations of the law, will lead to efficient adherence to the law. We discuss, in Appendix A, some of the basic principles of this literature. The economics literature on the topic starts from the proposition, apparently rejected for no discernable reason by BellSouth's economists, that when assessing incentives to violate the law, one must compare the profits from violating the law with the penalties that are incurred for a violation that was detected. BellSouth's economists uniformly argue that, whether the issue is cross-subsidization or discrimination, BellSouth would refrain from such activity simply because it is illegal.[53]

80. Other RBOCs fully understand the principle that toothless penalties lead to inefficiently low levels of compliance with the law. For example, Ameritech has complained that an FCC ruling favorable to its Ameritech New Media cable television might be a pyrrhic victory because, while the FCC found that a programming entity owned by a major incumbent cable multi-system operator ("MSO") discriminated against Ameritech's cable television operations, the lack of a substantial financial penalty for the illegal activity renders the decision ineffective in deterring future violations:

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[53]The theory of law and economics according to BellSouth's economists, of course, suggests an obvious solution to the alleged problem that the IXCs are delaying profitable entry into local service in order to preserve even greater profits in long distance — just pass a law saying that the IXCs cannot delay local entry if economic conditions would warrant such entry. However, to ensure a level playing field between the RBOCs and the IXCs we must make sure that any finding by any regulator that any IXC has violated this law carries no meaningful penalty.

> "We're pleased by the FCC's ruling, although it's unfortunate in one respect," said Deb Lenart, president of Ameritech New Media. "The fact that Rainbow was not penalized for breaking the law reinforces what we've been saying all along - that the program access rules need some meat on the bone. Without the risk of incurring financial penalties, companies have little incentive to follow the rules."[54]

81. Second, BellSouth's economists (as well as BellSouth) have internally inconsistent views on the efficacy of regulation. Their views on regulation seem to depend critically on whose ox is being gored. When the issue is whether regulation can prevent the RBOCs from acting on their incentives to discriminate or cross-subsidize (i.e., when regulatory failure results in the IXCs' oxen being gored), BellSouth and its economists argue that regulators are extremely competent and efficient. However, when considering how the FCC has chosen to implement the unbundling requirements of the 1996 Telecommunications Act (where the RBOCs view their oxen as being gored by prices that are too low), the FCC and state regulators who agree with its costing principles are grossly incompetent. The clearest example of the conflict is provided by the views of Dr. Hausman. He argues that the TELRIC methodology (advocated by the FCC, DOJ, and many states) for pricing unbundled network elements is likely to understate the true costs by 200 to 300%.[55] So when costing out network elements, regulators (or at least many regulators) are grossly incompetent. However, when it comes to analyzing the cost issues

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[54]Ameritech New Media press release, September 25, 1997.

[55]See *Reply Affidavit of Jerry A. Hausman*, In the Matter of Implementation of the Local Competition Provisions in the Telecommunications Act of 1996, CC-Docket No. 96-98 (May 1996).

relevant to cross-subsidization or discrimination, regulators are quite competent, and there is no risk that anticompetitive behavior will not be immediately detected.[56]

82. Third, BellSouth's economists do not address at all the major discrimination concern that we and Dr. Schwartz for DOJ have identified. Even if antidiscrimination regulation works acceptably at times when technology is stable, as technology changes, the ability of regulators to prevent discrimination is dramatically reduced. And regulation cannot be expected to induce vertical cooperation that may be necessary to plan and implement a change in technology. BellSouth's economists choose to focus only on whether equal access rules are working well in the current technical environment (see Dr. Hausman's declaration at paragraph 40 and Dr. Gilbert's affidavit at paragraphs 48-50). They approvingly cite Dr. Schwartz' opinion that to date there does not appear to have been discrimination in access by other LECs who have entered interLATA service, and conveniently ignore Dr. Schwartz' and our view that antidiscrimination regulation is inherently prone to failure as technology changes. This allows them to escape the logical conclusion that follows — for local competition to be irreversibly established, substantial facilities-based entry is necessary.

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[56]See *Declaration of Professor Jerry A. Hausman*, filed on behalf of BellSouth in CC Docket No. 97-208, at 23-27 (Sept. 26, 1997) (section IV, entitled "Regulation Eliminates Hypothetical Competitive Distortions as a Significant Concern").

83. Fourth, BellSouth's economists incorrectly conclude that there is no problem with interim rates for unbundled elements because customers in transactions covered by the interim rate will not have to pay a higher final rate for past transactions, if the South Carolina Public Service Commission ends up selecting a final rate higher than the interim rate. But this price protection covers only a small part of the problem. A CLEC must sink costs in its own operations, even where it is relying on unbundled network elements purchased from the ILEC. Local facilities are long-lived assets. The return to investment, and therefore the incentive to invest, depends on input prices over the life of the investment. Consider an asset with a ten year life. Suppose that a CLEC invests today in South Carolina. It knows the interim rate for inputs purchased from BellSouth applies until a final rate is promulgated. Suppose that the final rate will be known in one year. Then the entrant has price protection at the interim rate for one tenth of the life of its local service investment. It faces input price uncertainty over the other ninety per cent of the asset's life. The price protection required by the South Carolina commission has some value to entrants, but that value is quite limited. It is certainly not sufficient for the FCC to change its policy of requiring that final rates, and not interim rates, be in effect before a section 271 application is granted.

84. Fifth, Professor Schmalensee (paragraphs 38-48) contests the view that access charge pricing distortions should be corrected before the RBOCs are allowed to enter long distance. However, despite the fact that Professor Schmalensee promises to address the various reasons that have been advanced for this sequencing, he simply ignores our argument (discussed here in

section III, but which has been presented previously in other federal and state section 271 proceedings) for requiring access price correction before allowing the RBOCs to enter long distance.

VI. SUMMARY

85. The line of business restrictions in the MFJ were based on the incentives for the RBOCs to enter markets adjacent to their bottleneck local exchange operations in order to evade the constraints regulators were placing on their prices and profits in local exchange services. In our view, the public interest consideration in section 271 still requires substantial, facilities-based competition before the RBOCs should be allowed to provide interLATA long-distance service. At that point, competitors in adjacent markets (long distance) no longer need rely exclusively for an essential input on firms with strong anticompetitive incentives.

86. InterLATA long distance is not the only business that can be adversely affected by a premature grant of interLATA authority. The Telecommunications Act of 1996 opens local exchange markets to competition. Premature interLATA authority will give the RBOCs a greater ability to engage in behavior that can foreclose or delay local competition, such as signing up important customers to long-term contracts for bundled services, cutting prices selectively to customers most likely to patronize new entrants, raising customer switching costs, and sabotaging attempts by new local competitors to rely in part on Ameritech's facilities as they begin to provide local service.